888. *Price Cap Eligible Recovery.* Price Cap Eligible Recovery in a given year is the cumulative reduction in a particular intercarrier compensation rate since the base year multiplied by the pre-determined minutes for that rate for that year, as defined above.

> **Price Cap Example.**[1719] A price cap carrier has a 2011 intrastate terminating access rate for transport and switching of $.0028, an interstate terminating access rate for transport and switching of $.0020, and 10,000,000 Intrastate Base Minutes. Its Eligible Recovery for intrastate switched access revenue would be determined as follows:
>
> *Year 1.* Reduce intrastate terminating access rate for transport and switching, if above the carrier's interstate access rate, by 50 percent of the differential between the rate and the carrier's interstate access rate.
>
> The carrier's Year 1 (Y1) Minutes equal 9,000,000 (10,000,000 x .9). Its intrastate terminating access rate for transport and switching, $.0028 in 2011, is reduced by $.0004 (($.0028-$.0020) x 50 percent)) to $.0024. Its Y1 Eligible Recovery is $3,600 ($.0004 x 9,000,000). For a *CALLS* study areas, Eligible Recovery would be reduced by an additional 10 percent to $3,240 ($3,600 x .9). For a non-*CALLS* study area, such reductions will begin in year six.
>
> *Year 2.* Reduce intrastate terminating access rate for transport and switching, if above the carrier's interstate access rate, to the carrier's interstate access rate.
>
> The carrier's Year 2 (Y2) Minutes equal 8,100,000 (9,000,000 x .9). Its intrastate terminating access rate for transport and switching is reduced by an additional $.0004 from $.0024 to $.0020, for a cumulative reduction of $.0008. Its Y2 Eligible Recovery is $6,480 ($.0008 x 8,100,000). For a *CALLS* study area, Eligible Recovery would be reduced by an additional 10 percent to $5,832 ($6,480 x .9). For a non-*CALLS* study area, such reductions will begin in year six.

889. *This Approach to Recovery for Price Cap Carriers Provides Certainty and Encourages Efficiency.* Under the Act, the Commission has "broad discretion in selecting regulatory tools, [which] specifically includes 'selecting methods . . . to make and oversee rates,'"[1720] and is not compelled to follow any "particular regulatory model."[1721] Our approach to defining Price Cap Eligible Recovery continues to give those incumbent LECs incentives for efficiency while also providing greater predictability for carriers and consumers. Under price cap regulation, incumbent LECs already have significant incentives to control their costs associated with services provided to end-users, but have not had the same incentives to limit the costs imposed on IXCs for terminating calls on the price cap incumbent LECs' networks. These costs are ultimately borne by the IXCs' customers generally, rather than by the price cap LECs' customers specifically. By phasing out those termination charges and

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[1719] This is a simplified example of the calculation of Price Cap Eligible Recovery for a price cap carrier's reduction in intrastate terminating access resulting from the reforms we adopt for illustrative purposes only. It is not intended to encompass all necessary calculations applicable in determining Price Cap Eligible Recovery in the periods discussed in the example for all possible rates addressed by our Order.

[1720] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3297-98, para. 194 (citations omitted) (1988). *See also LEC Price Cap Order* at 6836, paras. 401-03.

[1721] *Id.* Consequently, we disagree with commenters that suggest we lack authority to adopt such an approach. *See, e.g.*, Blooston Rural Carriers *USF/ICC Transformation NPRM* Comments at 23-36. Some of these commenters object to particular ways of implementing recovery that they view as problematic. *See, e.g.*, Alexicon *USF/ICC Transformation NPRM* Comments at 33 & Exh. D. Because the recovery mechanism adopted here differs from those envisioned by those commenters, those filings do not dissuade us from taking this approach.

providing recovery in part through limited end-user charges, our reform will provide price cap LECs incentives to minimize such costs as they transition to broadband networks.

890. We have considered a number of alternative proposals regarding the elimination of intercarrier terminating switched access charges and find that the approach we adopt today constitutes a hybrid of a variety of proposals that best protects consumers while facilitating the reasonable transition to an all-broadband network. Some commenters have argued that no additional recovery should be allowed absent a specific showing that denying recovery would constitute a taking.[1722] Based upon the record in this proceeding, we conclude that such a denial would represent a flash-cut for price cap LECs, which is inconsistent with our commitment to a gradual transition and could threaten their ability to invest in extending broadband networks. We also find that denying any recovery pending the adjudication of a request for an exogenous low-end adjustment under our price cap rules[1723] would be unduly burdensome for carriers and for the Commission because of the number of claims the carriers would be required to file and the Commission would be required to adjudicate.[1724] Our definition of Price Cap Eligible Recovery for both *CALLS* and non-*CALLS* study areas gives predictability not only to price cap carriers, but also to consumers and universal service contributors, given the fluctuations that could result from a true-up approach for these large carriers.[1725]

3. Calculating Eligible Recovery for Rate-of-Return Incumbent LECs

891. For rate-of-return incumbent LECs, we adopt a recovery mechanism that provides more certainty and predictability than exists today, while also rewarding carriers for efficiencies achieved in switching costs. Specifically, the recovery mechanism will allow interstate rate-of-return carriers to determine at the outset of the transition their total ICC and recovery revenues for all transitioned rate elements, for each year of the transition: Eligible Recovery will be adjusted as necessary with annual true ups to ensure that rate-of-return carriers have the opportunity to receive their Baseline Revenue, notwithstanding changes in demand for their intercarrier compensation rates being capped or reduced under our Order. We find that providing this greater degree of certainty for rate-of-return carriers, which are generally smaller and less able to respond to changes in market conditions than are price cap carriers, is necessary to provide a reasonable transition from the existing intercarrier compensation system.[1726]

892. As the starting point for calculating the Rate-of Return-Baseline, we will use a rate of return carrier's 2011 interstate switched access revenue requirement, plus FY2011 intrastate switched access revenues and FY2011 net reciprocal compensation revenues.[1727] We will then adjust this Baseline

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[1722] *See*, e.g., Free Press *USF/ICC Transformation NPRM* Comments at 3, NASUCA *USF/ICC Transformation NPRM* Comments at 20.

[1723] *See* 47 C.F.R. § 69.3(b)

[1724] Unlike some proposals in the record, *see, e.g.*, ABC Plan, Attach. 1 at 11-12, we require carriers to seek recovery first from all their customers—residential and single-line business customers as well as multi-line business customers—rather than from residential customers only. This will reduce the burden on residential customers and the CAF.

[1725] *See, e.g.*, T-Mobile *August 3 PN* Comments at 19-20; Comcast *August 3 PN* Comments at 15.

[1726] *See e.g.*, Letter from Lawrence Zawalick, Senior Vice President, Rural Telephone Finance Cooperative, to Julius Genachowski, Chairman, FCC, WC Docket Nos. 10-90, 07-135, 05-337 and 03-109, GN Docket No. 09-51 and CC Docket Nos. 01-92 and 96-45, Attach. at 10 (noting that, for rate-of-return carriers, the "[c]apital markets and private lenders would react positively to regulatory certainty and cash flow stability").

[1727] Average schedule carriers will use projected settlements associated with 2011 annual interstate switched access tariff filing.

over time to reflect trends in the *status quo* absent reform. Under the interstate regulation that has historically applied to them, rate-of-return carriers were able to increase *interstate* access rates to offset declining MOU, which has averaged 10 percent per year, and consequently had insufficient incentive to reduce costs despite rapidly decreasing demand.[1728] However, the record indicates that, in the aggregate, rate-of-return carriers' interstate switched access revenue requirement has been declining approximately three percent each year, reflecting declines in switching costs.[1729] As a result, interstate switched access revenues have been declining at approximately three percent annually. NECA and a number of rate-of-return carriers project that the revenue requirement will continue to decline at approximately three percent a year over the next five years, because switching costs are declining dramatically given the availability of IP-based softswitches, which are significantly less costly and more efficient than the TDM-based switches they replace.[1730] Similarly, the record reveals that legacy LSS, which is being incorporated in our recovery mechanism for rate-of-return carriers, is projected to decline approximately two percent per year, likewise resulting in reduced interstate revenues for carriers receiving LSS.[1731]

893. In the intrastate jurisdiction, moreover, the majority of states do not have an annual true-up mechanism; intrastate rates generally do not automatically increase as demand declines and as a result, most rate-of-return carriers have been experiencing significant annual declines in intercarrier

[1728] *See supra* paras. 885-886.

[1729] Letter from Jeffrey E. Dupree, Vice President—Government Relations, NECA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109; CC Docket Nos. 01-92, 96-45; GN Docket No. 09-51, Attach. 2, at 1 (filed Aug. 29, 2011) ("Preliminary RLEC CAF Computations") (NECA et al. Aug. 29, 2011 *Ex Parte* Letter).

[1730] *See supra* para. 752. Softswitches are modular general-purpose hardware programmed to control voice calls across TDM- and IP-based networks. *See* William Stallings, Data and Computer Communications, 8th ed., at 307, Pearson Prentice Hall, Upper Saddle River NJ, 2007. The use of softswitches permits carriers to reduce capital and operating costs for a range of reasons. As a straight replacement for a legacy specialized Class 5 central office switch, a softswitch is said to save 70 percent in space, 60 percent in power, and up to 50 percent operating expenses in certain situations. *See, e.g., id.*; Google *August 3 PN* Comments at 8 n.28; Franklin D. Ohrtman, Jr, Softswitch: Architecture for VoIP, McGraw-Hill, New York, NY, 2003 (Chapter 11 passim, compare with page 57: "A Class 5 switch can cost tens of thousands of dollars and require at least half a city block in real estate."); http://www.genband.com/Home/Solutions/Fixed/Network-Transformation-Large-Office.aspx; and http://www.metaswitch.com/wireline/Local-Exchange-Evolution.aspx and http://www.ericsson.com/res/docs/whitepapers/efficient_softswitching.pdf. Costs are also reduced when softswitches are used to gain the efficiencies of IP technologies. In addition, open softswitch software architectures allow carriers to expand service offerings, spreading fixed costs over more services. *See, e.g*, , Jr., Softswitch: Architecture for VoIP, McGraw-Hill, New York, NY, 2003, especially chapter 11; Florida PSC *USF/ICC Transformation NPRM* Comments at 7-8; *see also* Letter from Jason J. Dandridge, CEO, Palmetto Rural Telephone Cooperative, to Albert M. Lewis, Chief, Pricing Policy Division, Wireline Competition Bureau, at 5 (filed Sept. 9, 2009) ("The new softswitch will help to position the Cooperative to use VoIP if it chooses to do so in the future, which will generate substantial cost savings for Palmetto."). We therefore reject concerns raised by the rate-of-return carriers that the recovery mechanism disincents investment in softswitches. *See*, Letter from Michael R. Romano, Senior Vice President – Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 2 (filed October 17, 2011); Letter from Michael R. Romano, Senior Vice President – Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 5 (filed Oct. 19, 2011). To the contrary, evidence overwhelmingly indicates that such switches are significantly more efficient and carriers that reap the benefits of efficiencies, including for example by sharing a softswitch, will be able to retain additional revenues. *See, e.g.*, Viearo Wireless *August 3 PN* Comments, Exh. 2 at 17, 39-40, 45-46.

[1731] NTCA Sept. 9, 2011 *Ex Parte* Letter, Attach. 3 at 1.

compensation revenue.[1732] In particular, aggregate data from more than 600 rate-of-return carriers reveals an average decline in intrastate MOUs of approximately 11 percent, and an average decline in intrastate access revenues of approximately 10 percent annually.[1733] Our recovery mechanism accounts for this existing revenue loss, which would continue to occur under the *status quo* path absent reform, as illustrated in the figure below.[1734]

[1732] We are aware of only a few states conduct some form of annual review to allow incumbent LECs to modify intrastate intercarrier compensation in response to changes in demand or to otherwise replace those revenues through other processes in whole or in part. *See, e.g., Alaska Exchange Carrier's Ass'n v. Regulatory Comm'n of Alaska*, No. S-13528, 2011 WL 4715209 (Alaska rel. Oct. 7, 2011); *Fourteen Small Incumbent Local Exchange Carriers and the California High Cost Fund-A Administrative Committee Fund*, Resolution T-17298, 2011 WL 660558 (Cal. PUC rel. Jan. 27, 2011); *Implementation of House Bill 168*, Docket No. 32235, Order Implementing House Bill 168, 2010 WL 4925826 (Ga. Pub. Serv. Comm'n rel. Nov. 23, 2010); KAN. STAT. ANN. § 66-2005(c). The record does not indicate that most states have such a process. Rather, in other states, there are not automatic annual true-ups, whether because carriers instead must request permission to increase rates through a formal rate case or a less formal process, because rates are specified by statute, or because interstate rate-of-return carriers are subject to some alternative form of regulation at the state level. *See, e.g.*, ABC Plan Proponents *August 3 PN* Comments at 5; Florida PSC *USF/ICC Transformation NPRM* Comments at 5; Cincinnati Bell *2008 Order and ICC/USF FNPRM* Comments at 15-16; *Investigation Into Streamlining the Procedures and Filing Requirements For Intrastate Access Tariffs that Implement or Maintain Parity with Interstate Tariffs*, Cause No. 44004, Order, 2011 WL 2908623 (Ind. Util. Reg. Comm'n rel. July 13, 2011); *Application of Highland Telephone Cooperative, Inc. for an Adjustment of Rates*, Case No. 2010-00227, Order, 2011 WL 2678154 (Ky. Pub. Serv. Comm'n rel. July 7, 2011); *Intrastate Access Charge Policies*, Application No. C-4145/NUSF-74/PI-147, Order, 2010 WL 2650347 (Ne. Pub. Serv. Comm'n rel. Apr. 20, 2010); *Investigation into the Earnings of Citizens Telephone Company of Higginsville, Missouri*, Case No. IR-2005-0024, Order Approving Stipulation and Agreement, 2004 WL 1855412 (Mo. Pub. Serv. Comm'n rel. Aug. 12, 2004); *Illinois Independent Telephone Association*, Docket 01-0808, Order, 2003 WL 23234577 (Il Commerce Comm'n rel. Nov. 25, 2003); 65-407 ME CODE Ch. 280 § 8; Mich. Comp. Laws ch. 484.2310 § 310(12); 2007 Nevada Laws Ch. 216 (A.B. 518); Tenn. Code Ann. § 65-5-302; Wis. Stat. § 196.212; Wy Stat. § 37-15-203(j); *see also* James C. Bonbright, et al., PRINCIPLES OF PUBLIC UTILITY RATES at 96, 198 (2d ed. 1988) (discussing regulatory lag as a common feature of rate regulation); W. Kip Viscusi, et al., Economics of Regulation and Antitrust at 432-33 (4th ed. 2005) (discussing regulatory lag and its effects).

[1733] Letter from Regina McNeil, VP of Legal, General Counsel & Corporate Secretary, NECA to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, GN Docket No. 09-51, CC Docket No. 01-92 (filed May 25, 2011).

[1734] NECA Dec. 29, 2010 *Ex Parte* Letter; NECA May 25, 2011 *Ex Parte* Letter; NECA Aug. 29, 2011 *Ex Parte* Letter; FCC staff analysis of data *available at* http://www.usac.org/hc/tools/disbursements/default.aspx. For purposes of this chart, trends in reciprocal compensation MOUs are assumed to follow trends for intrastate access MOUs.

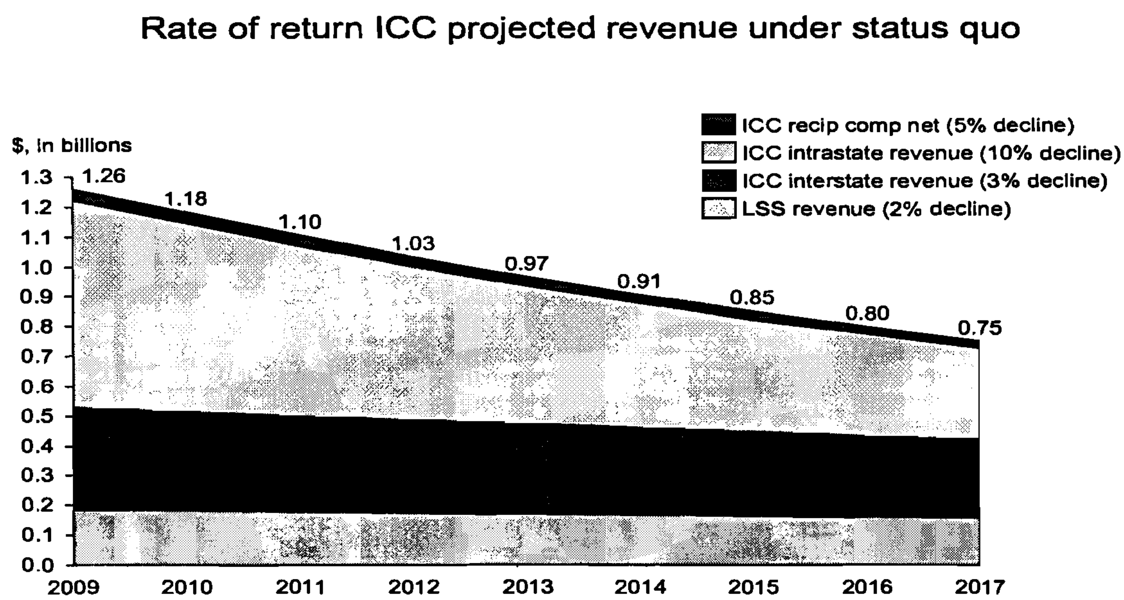

Figure 11[1735]

894. Accounting for both the declining interstate revenue requirement and the ongoing loss of intrastate revenue with declining MOU, the record establishes a range of reasonable potential annual reductions in the Baseline from which Rate-of-Return Eligible Recovery is calculated; within that range we initially adopt a five percent annual decrease. At the lower end of the range, an annual decrease of three percent would represent rate-of-return carriers' approximate annual interstate revenue decline absent reform.[1736] Limiting our Baseline adjustment to three percent would make these carriers substantially better off with respect to their intrastate access revenues, however. As discussed above, carriers in many states do not have annual true-ups under state access rate regulations so as MOU decline, intrastate access revenues decline as well. Data indicate that this intrastate access revenue decline has been approximately 10 percent.[1737] Combining these interstate and intrastate declines weighted by the relative portion of aggregate rate-of-return revenues subject to the mechanism attributable to each category could justify a

[1735] According to NECA, intrastate access is approximately 56 percent of these revenues, interstate access is approximately 28 percent of these revenues, and LSS is approximately 16 percent of these revenues. *See* Letter from Joe A. Douglas, Vice President, Government Relations, NECA, to Marlene H. Dortch, Secretary, FCC, CC Docket Nos. 96-45, 80-286, GN Docket No. 09-51 at Attach. (filed Dec. 30, 2010) (providing revenue figures); NTCA Sept. 9, 2011 *Ex Parte* Letter Attach. 3 at 1 (providing revenue and LSS change projections). Using a 10 percent annual decline for intrastate access revenues, 3 percent annual decline for the interstate access revenue requirement, and 2 percent annual decline for LSS yields a weighted annual decline of approximately 7 percent.

[1736] *See* NTCA Sept. 9, 2011 *Ex Parte* Letter Attach. 3 at 1. We note that this revenue requirement includes a prescribed rate of return of 11.25 percent. Although the rate-of-return carriers proposed a 10 percent rate of return as part of their reform proposal, rate represcription is addressed in the FNPRM and is not part of this analysis. *See infra* Section XVII.C.

[1737] Letter from Regina McNeil, VP of Legal, General Counsel & Corporate Secretary, NECA to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, GN Docket No. 09-51, CC Docket No. 01-92 (filed May 25, 2011).

possible Baseline reduction of approximately seven percent annually.[1738] Because we recognize that our approach to recovery may require adjustments by rate-of-return carriers, we initially adopt a conservative approach and limit the decline in the Baseline amount from which Rate-of-Return Eligible Recovery is calculated to five percent annually.[1739]

895. Moreover, we note that the annual five percent decline does not include the proposal in the *USF/ICC Transformation NPRM* and from the Rural Associations to apply the corporate operations expense limitation to LSS.[1740] LSS offsets a portion of rate-of-return carriers' interstate switched access revenue requirement. Applying the corporate operations expense limitations to LSS, or more generally to the entire switched access interstate revenue requirement, would have resulted in one-time reduction of almost three percent.[1741] By foregoing this reduction before setting the Baseline, we ensure that the five percent decline is appropriately conservative, while still consistent with our overall goals to encourage efficiency and cost savings.

896. Rate-of-return carriers will receive each year's Baseline revenue amount from three sources. First, they will continue to have an opportunity to receive intercarrier compensation revenues, pursuant to the rate reforms described above. Second, they will have an opportunity to collect ARC revenue from their customers, subject to the consumer protection limitations set forth below. Third, they will have an opportunity to collect any remaining Baseline revenue from the CAF. Together, the second and third sources comprise the Rate-of-Return Eligible Recovery.

897. Specifically, Rate-of-Return Eligible Recovery will be calculated from the Rate of Return Baseline by subtracting an amount equal to each carrier's opportunity to collect ICC from the rate elements reformed by this Order. In each year, this ICC opportunity will be calculated as actual demand for each reformed rate element times the default intercarrier compensation rate for that element in that year. The intercarrier glide path adopted above sets default transitional ICC rates, and permits carriers to negotiate alternatives.[1742] In computing the opportunity to collect ICC, we will use the default rates rather than any actual rate to prevent carriers from negotiating low rates simply to prematurely shift intercarrier compensation revenues to the CAF. Thus, in the event that a carrier negotiates intercarrier compensation

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[1738] *See supra* note 1735.

We note that some commenters have projected an 8 percent decline in intrastate access MOUs. *See* NTCA Sept. 9, 2011 *Ex Parte* Letter, Attach. 4 ("RLEC RM Price-Out by State and Interstate Component") (8 percent estimate). Although we find the trend based on actual historical results more reliable, even if we instead used that lower projected MOU loss as a proxy for associated intratstate revenue loss (i.e., an 8 percent revenue loss), this still would yield a weighted annual decline of approximately 6 percent.

[1739] We seek comment in the FNPRM asking whether we should change this baseline reduction after five years by either moving to a decline based on MOUs or increasing the decline by one percent per year up to a 10 percent decline. *See infra* para. 1329.

[1740] *See USF/ICC Transformation NPRM*, 26FCC Rcd at 4624, para. 198. *See* Letter from Joshua Seidemann, Director of Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 10-90; GN Docket No. 09-51; WC Docket Nos. 07-135, 05-377; CC Docket No. 01-92, Attach. at 1 (filed Aug. 26, 2011).

[1741] Staff analysis of local switching support data provided by NECA (submitted by NECA as confidential). *See, NECA Data Filings.*

[1742] See infra Section XII.C.

rates lower than those specified, we will still impute the full default rates, for the purpose of computing the amount each carrier has an opportunity to collect from ICC.[1743]

898. Carriers will annually estimate their anticipated MOU for each relevant intercarrier compensation rate capped or reduced by this Order. We note that carriers already use forecasts today in their annual access filings to determine interstate switched access charges and we are requiring carriers to use similar methodology to forecast intercarrier compensation for use in determining Rate-of-Return Eligible Recovery. Because estimated minutes likely will differ from actual minutes, there will be a true-up in two years to adjust the carrier's Rate-of-Return Eligible Recovery for that year to account for the difference between forecast MOU and actual MOU in the year being trued-up.[1744] These data on MOU will establish the Base Minutes for each relevant category, and shall not include MOU for which revenues were not recovered, for whatever reason.[1745] Rate-of-return carriers will be required to submit to the states the data used in these calculations,[1746] allowing state regulators to monitor implementation of the recovery mechanism.[1747] A rate-of-return incumbent LEC that is eligible to receive CAF shall also file this information with USAC, and we delegate to the Wireline Competition Bureau authority to work with to USAC to develop and implement processes for administration of CAF ICC support.[1748] In support of the carriers' annual access tariff filing, each carrier will provide the necessary data used to justify any ARC to the Commission.

899. *Rate-of-Return Eligible Recovery.* A rate-of-return carrier's baseline for recovery ("Rate-of-Return Baseline") is its 2011 interstate switched access revenue requirement, plus its FY2011[1749] intrastate switched access intercarrier compensation revenues for rates capped or reduced by this Order, plus its FY2011 net reciprocal compensation revenues. A rate-of-return carrier's Eligible Recovery ("Rate-of-Return Eligible Recovery"), in turn, is: (a) its Rate-of-Return Baseline reduced by five percent each year; less (b) its ICC recovery opportunity for that year, defined as: (i) its estimated MOU for each

[1743] To do so, carriers are required to file data annually to ensure that carriers do not recover more than they are entitled under the recovery mechanism we adopt today.

[1744] In the FNPRM we seek comment on when the true-up process should end, and what the appropriate replacement should be. *See infra* para. 1329.

[1745] Carriers may, however, request a waiver of our rules defining the Baseline to account for revenues billed for terminating switched access service or reciprocal compensation provided in FY2011 but recovered after the March 31, 2012 cut-off as the result of the decision of a court or regulatory agency of competent jurisdiction. The adjusted Baseline will not include settlements regarding charges after the March 31, 2012 cut-off, and any carrier requesting such modification to its Baseline shall, in addition to otherwise satisfying the waiver criteria, have the burden of demonstrating that the revenues are not already included in its Baseline, including providing a certification to the Commission to that effect. Any request for such a waiver also should include a copy of the decision requiring payment of the disputed intercarrier compensation. Any such waiver would be subject to the Commission's traditional "good cause" waiver standard, rather than the Total Cost and Earnings Review specified below. *See* 47 C.F.R. § 1.3.

[1746] *See supra* paras. 812-813. Upon request, carriers will also be required to file this data with the Commission.

[1747] As discussed above, rate-of-return carriers may elect to have NECA or another entity perform and submit the annual analysis. *See supra* note. 1690.

[1748] USAC plays a critical role in the day-to-day administration of universal service support mechanisms, *see, e.g., USF/ICC Transformation NPRM*, 26 FCC Rcd at 4595, para. 116 n.192, including the ICC-replacement CAF support that is part of our recovery mechanism.

[1749] I.e., October 1, 2010 through September 30, 2011.

rate element subject to reform times; (ii) the default transition rate for that rate element for that year; plus (3) any necessary true-ups based on the prior year's actual MOUs.

> **Rate of Return Example.**[1750] A rate-of-return carrier has a 2011 interstate switched access revenue requirement of $200,000, FY2011 intrastate switched access revenues of $50,000, and net reciprocal compensation revenues of $5,000. Its Eligible Recovery would be determined as follows:
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> *Year 1*. The carrier is entitled to collect $242,250 ($255,000 x .95). The carrier will subtract from this total its ICC recovery opportunity from switched access charges capped or reduced in this Order (both intrastate and interstate) and net reciprocal compensation, defined as its forecast MOU times the default rates specified by this Order. The remainder is Eligible Recovery.
>
> *Year 2*. Prior to adjustment for any under- or over-estimation of minutes in Year 1, the carrier is entitled to recover $230,137.50 ($242,250 x .95). This figure is adjusted up or down in the annual true-up to reflect any difference between forecast minutes in Year 1 and actual minutes in Year 1. For example, if the carrier had fewer minutes than estimated in Year 1, such that its ICC recovery opportunity was $500 less than forecast, its recovery in Year 2 would be adjusted upward by $500 and it would be permitted to recover $230,637.50 in Year 2 ($230,137.50 + $500). Conversely, if the carrier had a higher number of MOU than had been forecast and provided the carrier an opportunity for $500 more ICC recovery, its recovery in Year 2 would be adjusted downward to $229,637.50 ($230,137.50 - $500). The carrier will then subtract from this total its Year 2 ICC recovery opportunity, based on its Year 2 forecast minutes and the Year 2 default rates specified by this Order. The remainder is Eligible Recovery.

900. *This Approach to Recovery for Interstate Rate-of-Return Carriers Provides Certainty, Minimizes Burdens to Consumers, and Constrains the Size of USF.* Exercising our flexibility under the Act to design specific regulatory tools,[1751] we adopt an approach to Rate-of-Return Eligible Recovery that takes interstate rate-of-return carriers off of rate-of-return based recovery specifically for interstate switched access revenues,[1752] but provides them more predictable recovery than exists under the *status quo*.[1753] Price cap carriers today already the bear the risk that costs increase and have no true up

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[1750] This is a simplified example of the calculation of Rate-of-Return Eligible Recovery for a rate-of-return carrier's reduction in intrastate terminating access resulting from the reforms we adopt for illustrative purposes only. It is not intended to encompass all necessary calculations applicable in determining Rate-of-Return Eligible Recovery in the periods discussed in the example for all possible rates addressed by our Order.

[1751] *See supra* para. 889.

[1752] In addition, to the extent that any interstate rate-of-return carriers also are subject to rate-of-return regulation at the state level, our recovery mechanism for switched access services replaces that, as well. We observe that our recovery mechanism otherwise leaves unaltered the preexisting rate regulations for these carriers' other services, such as common line (as modified by Sections VIII.C and D. of this Order) and special access. Nonetheless, we recognize that this approach represents a potentially significant regulatory change for those carriers and adopt a longer transition for these carriers for this reason. In addition to the benefits of the standard recovery mechanism discussed below, the Total Cost and Earnings Review mechanism we adopt today will ensure that this recovery mechanism will not deprive any carrier of the opportunity to earn a reasonable return.

[1753] *See, e.g.*, Mo STCG *USF/ICC Transformation NPRM* Reply at 10 ("[A]ny changes to small rate-of-return ILEC's revenue streams must be accompanied by a predictable and sufficient replacement mechanism."); FCC Universal Service Fund and Intercarrier Compensation Workshop, April 6, 2011, CC Docket No. 01-92 at 97, transcript *available at* http://www.fcc.gov/events/universal-service-fundintercarrier-compensation-reform-workshop (comments of Paul Gallant, Senior Vice President and Telecom Analyst, MF Global, discussing the importance of certainty of access revenue to allow continued investor support for broadband build-out).

mechanism for declines in demand. For this reason, the recovery mechanism we adopt for rate-of-return carriers is different than the recovery mechanism we adopt for price cap carriers. Although rate-of-return carriers have a true up process to the Eligible Recovery for actual demand, this is akin to how such carriers are regulated today.[1754] At the same time, however, we decline to conduct true-ups with regard to rate-of-return carriers' switched access costs; accordingly, carriers will have incentives to become more efficient and to reduce switching costs, including by investing in more efficient technology and by sharing switches. Carriers that are more efficient will be able to retain the benefits of the cost savings. We believe the rural LEC forecast with regard to reduced switched access costs is conservative, and carriers will have additional opportunities to recognize efficiencies with regard to these costs. We discuss these issues in greater detail below.

901. As discussed above, incumbent LECs are experiencing consistent, substantial, and accelerating declines in demand for switched access services.[1755] The effect of current interstate rate regulation is to insulate rate-of-return carriers from revenue loss due to competitive pressures that result in declining lines and MOU, but rapidly increasing access rates have exacerbated these carriers' risk of revenue uncertainty due to arbitrage,[1756] and carriers themselves project declining costs—and thus declining revenues—under the *status quo*. In the intrastate jurisdiction, as described above, carriers are often unable to automatically increase rates as they experience a decline in demand caused by competition and changing consumer usage, leading to declining intrastate revenues.[1757]

902. Our framework allows rate-of-return carriers to profit from reduced switching costs and increased productivity, ultimately benefitting consumers.[1758] We note in this regard that the transition to broadband networks affords smaller carriers opportunities for efficiencies not previously available. For example, small carriers may be able to realize efficiencies through measures such as sharing switches, measures that preexisting regulations, such as the thresholds for obtaining LSS support, may have deterred.[1759] Under the new recovery framework, carriers that realize these efficiencies will not experience a resulting reduction in support. In addition, our new recovery framework—in conjunction

[1754] The true-up process also protects carriers resulting from changes with regard to, for example, reforms related to various arbitrage schemes. The record does not allow us to quantify with precision the impact of these arbitrage-related reforms on rate-of-return carriers.

[1755] *See supra* paras. 885-856.

[1756] *See, e.g.*, Letter from Michael R. Romano, Sr. V.P. – Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, Docket No. 01-92, Attach. (filed July 18, 2011); Letter from Gregory W. Whiteaker, Herman & Whiteaker, LLC, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, CC Docket Nos. 01-92, 96-45, GN Docket No. 09-51, Attach. at 3 (filed Sept. 23, 2011) (NECA et al. Sept. 23, 2011 *Ex Parte* Letter).

[1757] *See supra* para. 893.

[1758] Our analysis is informed by the Commission's prior findings regarding the advantages that can arise from regulatory frameworks that encourage more efficient investment. *See, e.g.*, *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6789, para. 21 (1990) (*LEC Price Cap Order*). "[A] properly-designed system of incentive regulation will be an improved form of regulation, generating greater consumer benefits . . . ." *Id.* at 5 FCC Rcd 6786, para. 1. Not only have carriers been denied the benefits of increased efficiency under the current system, in some instances our rules actively discourage efficiencies. *See, e.g.*, 47 C.F.R. § 36.125(f). Competition is not a precondition for incentive-based regulation; the Commission previously has concluded that where there is limited competition there is "little incentive to become more productive. Applying incentive regulation to LECs is arguably a more significant regulatory reform in terms of its ability to generate consumer benefits than applying incentive regulation to a carrier or industry that faces substantial competition." *LEC Price Cap Order*, 5 FCC Rcd at 6790-91, para. 33.

[1759] *See USF/ICC Transformation NPRM*, 26 FCC Rcd at 4565, para. 21.

with the overall reforms adopted in this Order—provides revenue certainty, stability, and predictable support,[1760] as well as promoting continued investment,[1761] consistent with advantages some historically have associated with rate-of-return regulation.[1762]

903. Importantly, our approach also avoids the risk of unconstrained escalation in the burden on end-user customers and universal service contributors. We agree with commenters that, absent incentives for efficiency, determining recovery based on the historical approach to these carriers' rate regulation could cause the Connect America Fund to grow significantly and without constraint.[1763] This prediction is consistent with the Commission's past recognition that rate-of-return regulation can create incentives for inefficient investment, which would flow through to our recovery mechanism.[1764] Although some commenters contend that Commission accounting regulations and oversight adequately protect against inefficient investment,[1765] the effectiveness of Commission accounting regulations and oversight is limited in certain respects,[1766] as the Commission itself previously has recognized.[1767] More

[1760] *See supra* para. 858.

[1761] *See supra* Section VI.B.

[1762] *See, e.g., MAG Order*, 16 FCC Rcd at 19705, para. 220; *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, First Order on Reconsideration, CC Docket No. 00-256, Twenty-Fourth Order on Reconsideration, CC Docket No. 96-45, Report and Order, 17 FCC Rcd 5635, 5636, para. 2 (2002). We also observe that carriers will be able to continue to participate in NECA pooling. *See USF/ICC Transformation NPRM*, 26 FCC Rcd at 4741-42, para. 597 (citing the benefits of NECA pooling as a risk sharing mechanism for rate-of-return carriers).

[1763] *See, e.g.*, Ad Hoc *August 3 PN* Comments at 24 & n.39; CTIA *August 3 PN* Comments at 19 ; XO *August 3 PN* Comments at 15-16; Viaero Wireless *August 3 PN* Comments at 15-17 & Exh. 2. at 10-12, 15-20, 36-40, 43-51; Verizon *USF/ICC Transformation NPRM* Reply at 55; Letter from David L. Sieradzki, counsel for Alltel, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-337, CC Docket Nos. 01-92, 96-45, RM-10822, at 1-2 & Attach. (filed Mar. 6, 2007); Mercatus Center *Intercarrier Compensation FNPRM* Comments at 15, 22-23; Western Wireless Feb. 13, 2004 Comments, CC Docket No. 96-45, RM-10822 at Attach. As the Commission observed in the *USF/ICC Transformation NPRM*, "[o]ver time, aggregate high-cost support for rate-of-return carriers has increased, while such support for carriers that have chosen to move to price cap regulation has declined." *USF/ICC Transformation NPRM*, 26 FCC Rcd at 4611-12, para. 166 & Figure 7.

[1764] The Commission has found, for example, that because both decreases and increases in company costs are passed on to consumers, a rate-of-return regulated carrier has little incentive to manage inputs efficiently. *See, e.g., LEC Price Cap Order*, 5 FCC Rcd at 6789, para. 22; *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873, 2889-90, para. 30 (1989) (*AT&T Price Cap Order*); *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987); Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195, 3218-19, 3222, paras. 38, 43 (1988) (*Price Cap Further Notice*). The Commission also has observed that if the authorized rate-of-return exceeds the carrier's actual cost of capital, it may have an incentive to expand its rate base uneconomically. *See, e.g., Price Cap Further Notice*, 3 FCC Rcd at 3219-20, paras. 39-40; *AT&T Price Cap Order*, 4 FCC Rcd at 2889-90, para. 30. In addition, as the *USF/ICC Transformation NPRM* observed, other regulators likewise have trended away from rate-of-return regulation in recent years. *USF/ICC Transformation NPRM*, 26 FCC Rcd at 4740, para. 596 & n.888.

[1765] *See, e.g.*, Rural Broadband Alliance *August 3 PN* Comments at 23-24.

[1766] *See, e.g.*, Viaero Wireless *August 3 PN* Comments, Exh. 2. at 15-16 (citing backward-looking nature of regulatory constraints on investment, the relative information disparity between carriers and regulators, and the potential for cost-shifting or other actions that seek to evade constraints on certain costs); *id.*, Exh. 2 at 37-38 ("While it is possible to adopt a variety of constraints that would apply to specific expenditures, it is impossible to ascertain the effectiveness of those constraints absent an external benchmark").

broadly, as commenters observe, retaining rate-of-return regulation as historically employed by the Commission risks "perpetuat[ing the] isolated, ILEC-as-an island operation," thus increasing the costs subject to recovery to the extent that, for example, each individual incumbent LEC purchases its own facilities, rather than sharing infrastructure with other carriers where efficient.[1768] Of particular relevance here, as one commenter observes, under the preexisting regulatory framework "there is little evidence of shared investment in local switching, even though such sharing would be engaged in by rational carriers subject to market incentives," while, "[i]n contrast, there is evidence of at least some efforts to engage in joint ventures to invest in transport and tandem switching assets for which there are fewer regulatory incentives for rate-of-return carriers to invest in their own equipment and facilities."[1769] We are committed to constraining the growth of the CAF, and the recovery mechanism we adopt for interstate rate-of-return carriers advances that goal. To this end, states that have jurisdiction over intrastate access rates should monitor intrastate tariffs filed pursuant to the rules and reforms adopted in this Order to ensure carriers do not shift costs from services subject to incentive regulation to services still subject to rate-of-return regulation.

904. We decline to adopt the recovery mechanism proposed by associations of rate-of-return carriers.[1770] Although these carriers contend that their approach would allow intercarrier compensation reform for rate-of-return carriers that would limit the burdens placed on the CAF, we are not persuaded by a number of the assumptions that lead them to this conclusion. The rate-of-return carriers project that their revenue requirement for switched access will decline three percent annually for the next five years.[1771] Our approach locks in this historical trend, adjusted to account for the intrastate *status quo*. In the absence of locking in this historical trend, however, we have concerns about whether such declines in

(Continued from previous page)

[1767] For example, where regulated prices reflect reported costs, a carrier may have an incentive to exaggerate costs to secure higher prices. *See, e.g., LEC Price Cap Order*, 5 FCC Rcd at 6789, para. 22 ("Under rate of return, carriers are allowed to set their rates based on the costs—investment and expense—of providing a service. Carriers are given fairly wide latitude in the costs they can claim as the basis for their rates.") (citation omitted); *see also, e.g., LEC Price Cap Order*, 5 FCC Rcd at 6790, paras. 29-30; *AT&T Price Cap Order*, 4 FCC Rcd at 2889-90, paras. 30-31. Rate-of-return regulation also can enable carriers to shift some of the costs of their non-regulated, competitive services to the customers of their rate-of-return regulated services. *See, e.g., Price Cap Further Notice*, 3 FCC Rcd at 3223-24, para. 48.

[1768] *See, e.g.*, Viaero Wireless *August 3 PN* Comments, Exh. 2. at 18-19; *see also id.*, Exh. 2 at 19-20 (discussing discouragement of efficient consolidation among carriers).

[1769] Viaero Wireless *August 3 PN* Comments, Exh. 2. at 17 n.11; *see also id.*, Exh. 2 at 39-40, 45-46.

[1770] Letter from Walter B. McCormick, Jr., United States Telecom Ass'n, Robert S. Quinn, Jr., Senior Vice President—Federal Regulatory, AT&T, Melissa Newman, Vice President—Federal Regulatory Affairs, CenturyLink, Michael T. Skrivan, Vice President—Regulatory, FairPoint Communications, Kathleen Q. Abernathy, Chief Legal Officer and Executive Vice President—Regulatory and Government Affairs, Frontier, Kathleen Grillo, Senior Vice President—Federal Regulatory Affairs, Verizon, Michael D. Rhoda, Senior Vice President—Government Affairs, Windstream, Shirley Bloomfield, Chief Executive Officer, National Telecommunications Cooperative Association, John Rose, President, OPASTCO, Kelly Worthington, Executive Vice President, Western Telecommunications Alliance, to Chairman Genachowski, Commissioner Copps, Commissioner McDowell, and Commission Clyburn, at 2 (filed Jul. 29, 2011). (Submitted attached to Letter from Jonathan Banks, USTelecom, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92; WC Docket Nos. 05-337, 07-135, 10-90; GN Docket No. 09-51; CC Docket No. 96-45; WC Docket No. 06-122; CC Docket Nos. 99-200, 96-98, 99-68; WC Docket No. 04-36 (filed July 29, 2011)).

[1771] NECA et al. Aug. 29, 2011 *Ex Parte* Letter), Attach. 2 at 1 (Preliminary RLEC CAF Computations; Assumptions and Computations).

the revenue requirement actually will occur. As commenters observe, because ICC costs will be shifted primarily to the CAF to make rate-of-return carriers whole, carriers would face incentives for inefficient investment, and such incentives could be heightened to the extent that carriers seek to offset the effects of intercarrier compensation rate reductions.[1772] A more realistic view of the assumptions underlying the associations' projections suggests that the financial impact on the CAF of the associations' proposal is likely far greater than they project. Consequently, adopting their proposal appears likely to lead to one of two results—the CAF would grow significantly, or intercarrier compensation reform would stop once CAF demands outstripped the available budget.[1773]

F. Recovering Eligible Recovery

905. We now explain the two-step mechanism by which carriers will be allowed to recover their Eligible Recovery. First, incumbent LECs will be permitted to recover Eligible Recovery through limited end-user charges. If these charges are insufficient, carriers will be entitled to CAF support equal to the remaining Eligible Recovery.[1774] Because we view our recovery mechanism as a transitional tool, we implement several measures to ensure it is truly temporary in nature. First, the Eligible Recovery that incumbent LECs are permitted to recover phases down over time, based on a predetermined glide path for price cap carriers and a more gradual framework for rate-of-return carriers. Second, ICC-replacement CAF support for price cap carriers is subject to a defined sunset date. Finally, in the FNPRM, we seek further comment on the timing for eliminating the recovery mechanism—including end-user recovery—in its entirety. Carriers recovering eligible recovery will be required to certify annually that they are entitled to receive the recovery they are claiming and that they are complying with all rules pertaining to such recovery.

1. End User Recovery

906. The *USF/ICC Transformation NPRM* sought comment on the role that interstate SLCs should play in intercarrier compensation reform and the ongoing relevance of the SLC as the marketplace moves to IP networks.[1775] The subsequent *Public Notice* sought further comment on particular

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[1772] *See, e.g.*, CTIA *August 3 PN* Comments at 18; Free State Foundation *August 3 PN* Comments at 4; US Cellular *August 3 PN* Comments at 10-11.

[1773] As stated in the Joint Letter: "To the extent, however, that sufficient funding is not expected for any reason to be available to provide the necessary levels of high-cost support and/or intercarrier compensation restructuring for carriers in any given year, any and all reductions in intercarrier compensation rates shall be deferred until such sufficient funding is confirmed to be available." Joint Letter at 2-3. Similar concerns would arise from other proposals that rely on rate of return-based recovery in conjunction with more limited intercarrier compensation rate reforms. *See, e.g.*, NECA et al. *USF/ICC Transformation NPRM* Comments at 12-27; *see also*, Letter from Colin Sandy, Government Relations Counsel, NECA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 1-2 (filed Oct. 21, 2011).

[1774] Carriers electing to forego recovery from the ARC or the CAF must indicate their intention to do so in their 2012 tariff filing. Carriers may also elect to forgo CAF reform in any subsequent tariff filing. A carrier cannot, however, elect to receive CAF funding after a previous election not to do so. Notwithstanding a carrier's election to forego recovery from the ARC or the CAF, tariff filings may require carriers to provide the information necessary to justify the rates and terms in the tariff.

[1775] *USF/ICC Transformation NPRM*, 26 FCC Rcd at 4736, para. 579; *see also, e.g., 2008 USF/ICC FNPRM*, 24 FCC Rcd at 6497, App. A, paras. 298-310 (seeking comment on a recovery mechanism that would rely on certain SLC increases); *Intercarrier Compensation FNPRM*, 20 FCC Rcd at 4706-4734, paras. 42, 49, 51, 53, 54, 56, 59, 88, 101-02, 106, 108, 111 (seeking comment on recovery alternatives that would rely on SLC increases or other new end-user charges).

alternatives for using SLCs as part of any recovery mechanism.[1776] Although the record reveals a wide variety of proposals, most parties commenting on the matter supported an increase in end-user charges as a necessary part of ICC reform.[1777] In developing the recovery mechanism, we seek to balance the interests of both end-user customers and USF contributors. We thus agree that it is appropriate to first look to customers paying lower rates for some limited, reasonable recovery, and adopt a number of safeguards to ensure that rates remain affordable and that consumers are not required to contribute an inequitable share of lost intercarrier revenues.

907. In addition to balancing the needs of ratepayers and USF contributors, we also account for differences among different ratepayers, adopting particular protections for consumers. For example, some proposals in the record would require that end-user recovery be borne in the first instance by consumers.[1778] Instead, acknowledging that all end users benefit from the network, and consistent with the Commission's approach to end-user recovery in prior intercarrier compensation reform, we conclude that all end users should contribute to reasonable end-user recovery from the beginning of ICC reform.[1779]

908. We adopt a transitional ARC that is subject to three important constraints. First, in no case will the monthly ARC increase more than $0.50 per year for a residential or single-line business customer, or more than $1.00 (per line) per year for a multi-line business customer. Price cap incumbent LECs are allowed to increase ARCs for no more than five years; rate-of-return incumbent LECs for no more than six years.[1780] Second, in no case will the consumer ARC increase if that increase would result in certain residential end-user rates exceeding the Residential Rate Ceiling, which we discuss below. Third, ARCs can only be charged in a particular year to recover an incumbent LEC's Eligible Recovery for that year; total revenue from ARCs cannot exceed Eligible Recovery. Thus if a carrier's Eligible Recovery decreases from one year to the next, the total amount of ARCs it may charge its end users will also decrease. Importantly, carriers also are *not* required to charge the ARC.[1781]

[1776] *August 3 PN* at 10-16.

[1777] *See, e.g.*, Cbeyond et al. *USF/ICC Transformation NPRM* Comments at 15-16; CenturyLink *USF/ICC Transformation NPRM* Comments at 67, 69; Comcast *USF/ICC Transformation NPRM* Comments at 20; COMPTEL *USF/ICC Transformation NPRM* Comments at 36; Cox *USF/ICC Transformation NPRM* Comments at 14-15; Fidelity *USF/ICC Transformation NPRM* Comments at 13; ICore *USF/ICC Transformation NPRM* Comments at 21-22; Madison Telephone *USF/ICC Transformation NPRM* Comments at 14; Michigan PSC *USF/ICC Transformation NPRM* Comments at 18; Nebraska Rural Independent Companies *USF/ICC Transformation NPRM* Comments at 41; Sprint *USF/ICC Transformation NPRM* Comments at 13; T-Mobile *USF/ICC Transformation NPRM* Comments at 27; Vitelco *USF/ICC Transformation NPRM* Comments at 17; Wheat State *USF/ICC Transformation NPRM* Comments at 14; XO *USF/ICC Transformation NPRM* Comments at 49. *But see* Ad Hoc *USF/ICC Transformation NPRM* Comments at 56-62.

[1778] *See, e.g.*, ABC Plan Proponents *August 3 PN* Comments at 34-35.

[1779] *See, e.g.*, *Access Charge Reform Order*, 12 FCC Rcd at 16005 para. 58-60; *CALLS Order*, 15 FCC Rcd at 12978, para. 41; *MAG Order*, 16 FCC Rcd at 19634-35, paras. 43-44.

[1780] We believe that the consumer ARC adopted here, which, even if fully imposed, represents a smaller percentage increase than SLC increases adopted by the Commission in prior reforms, strikes the proper balance. *CALLS Order*, 15 FCC Rcd at 12991, 13004, paras. 76, 105-06; *MAG Order*, 16 FCC Rcd at 19634, 19638, paras. 42, 51.

[1781] Incumbent LECs may be unable to charge ARCs in whole or in part based on competitive constraints or other considerations, or may choose not to. *See, e.g.*, Letter from Jonathan Banks, USTelecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 10-90; GN Docket No. 09-51; WC Docket No. 07-135; WC Docket No. 05-337; CC Docket No. 01-92; CC Docket No. 96-45; WC Docket No. 04-36 at 1 (filed Oct. 17, 2011). Although we will impute the full permitted ARC revenues to those carriers for purposes of evaluating the need for additional recovery of Eligible Recovery, some commenters have suggested that carriers facing competition may choose to refrain from (continued...)

909. To minimize the consumer burden, we limit increases in the monthly consumer ARC to \$0.50 per year.[1782] Furthermore, while some commenters advocate end-user charges only for residential and single-line business customers, we reject requests to place the entire recovery burden on consumers. We provide for increases in the monthly ARC for multi-line business customers of \$1.00 (per line) per year, and we will require potential revenue from such increases to be imputed to carriers, reducing the total amount of consumer ARCs they may charge. Doing so is consistent with the Commission's prior intercarrier compensation reforms, which recognized that "universal service concerns are not as great for multi-line business lines."[1783] Consequently, in previous reforms, the Commission has adopted higher increases in end-user charges for multi-line business customers than for consumers, and on a more accelerated timeline. For example, in the *Access Charge Reform Order*, the Commission did not raise the SLC cap for primary residential and single-line business users,[1784] but concluded that universal service concerns were not as great for multi-line business users, for example, and raised the SLC caps for such users from \$6.00 to \$9.00 per line.[1785] In the *2008 ICC/USF Order and NPRM*, the Commission proposed increasing the residential and single-line business and the non-primary residential line SLC by \$1.50 and the multi-line business SLC by \$2.30.[1786] In the *USF/ICC Transformation NPRM* the Commission sought comment on those amounts again.[1787] Commenters supported this increase.[1788] In fact, some commenters advocated for a higher SLC increase.[1789] The ARC adopted today, which is lower on an annual basis than the annual SLC increase proposed in 2008, balances the burdens on consumers and businesses. However, we have taken measures to ensure that charges for multi-line businesses remain just and reasonable. In particular, to ensure that multi-line businesses' total SLC plus ARC line items are just and reasonable and to minimize the burden on businesses, we limit the maximum SLC plus ARC fee to \$12.20.[1790] This limits the ARC for multi-line businesses for entities at the current \$9.20 cap to \$3.00, comparable to the overall limit on residential ARCs.

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charging the ARC, and we preserve carriers' flexibility to do so. *See, e.g.*, AT&T *USF/ICC Transformation NPRM* Comments at 32.

1782 We also make clear that carriers may not charge any Lifeline customers an ARC. As a result, incumbent LECs' calculation of ARCs for purposes of the recovery mechanism must identify and exclude such customers. Given that our intercarrier compensation reforms also do not alter the operation of the existing SLC, these intercarrier compensation reforms will not affect the Lifeline universal service support mechanism.

1783 *MAG Order*, 16 FCC Rcd at 19638-39, para. 52.

1784 *Access Charge Reform Order*, 12 FCC Rcd at 16010-11 para. 73.

1785 *Access Charge Reform Order*, 12 FCC Rcd at 16005 para. 58-60.

1786 *See 2008 Order and ICC/USF FNPRM*, 24 FCC Rcd at 6630, para. 298

1787 *See USF/ICC Transformation NPRM*, 26 FCC Rcd at 4737, para. 582.

1788 *See, e.g.*, Frontier *2008 Order and ICC/USF FNPRM* Comments at 6; GVNW *2008 Order and ICC/USF FNPRM* Comments at 9; Cbeyond, et al. *USF/ICC Transformation NPRM* Comments at 15; Frontier *USF/ICC Transformation NPRM* Comments at 10; XO *USF/ICC Transformation NPRM* Comments at 49.

1789 *See* OPASTCO *2008 Order and ICC/USF FNPRM* Comments at 9-11.

1790 Several commenters urged the Commission to adopt some sort of cap on the overall multi-line business charges from the existing SLC and any new recovery charge. *See e.g.*, Letter from Henry Hultquist, VP, Federal Regulatory, AT&T Services, Inc. to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109; GN Docket No. 09-51; CC Docket Nos. 01-92, 96-45 (filed Oct. 21, 2011); Letter from Michael R. Romano, Senior Vice President – Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 4 (filed Oct. 17, 2011).

910. We permit carriers to determine at the holding company level how Eligible Recovery will be allocated among their incumbent LECs' ARCs.[1791] By providing this flexibility, carriers will be able to spread the recovery of Eligible Recovery among a broader set of customers, minimizing the increase experienced by any one customer.[1792] This also will enable carriers to more fully recover Eligible Recovery from end-users with rates below the $30 Residential Rate Ceiling, limiting the potential impact on the CAF.[1793] For carriers that elect to receive CAF support, we will impute to each carrier the full ARC revenues they are permitted to collect, regardless of whether they actually collect any or all such revenues. If the imputed amount is insufficient to cover all their Eligible Recovery, they are permitted to recover the remainder from CAF ICC support.

911. In the event a carrier elects not to receive CAF ICC support,[1794] we take measures to limit the burden on residential and single-line business customers. Absent doing so, carriers potentially could use their holding company-level flexibility to target their ARC recovery primarily or exclusively to residential and single-line business customers, rather than larger multi-line business customers. We therefore require that a carrier allocate its Eligible Recovery by a proportion of a carrier's mix of residential versus business lines. However, because line counts alone would not reflect the fact that there is a lower cap on ARC increases for residential and single-line business lines ($0.50 per line) than for multi-line business lines ($1.00 per line), we adopt a double-weighting of multi-line business lines for purposes of this calculation. The percentage of ARC revenues a carrier is eligible to recover from residential and single-line business customers cannot exceed the percentage of total residential lines assessed a SLC by such customers where multi-line business lines are given double weight.[1795] For example, if a carrier had 1000 residential and single-line business lines and 200 multi-line business lines, and Eligible Recovery of $600 monthly, under our limitation, it would be permitted to collect no more than 71.43 percent of that amount—approximately $429—from residential and single line business

[1791] *See, e.g.*, ABC Plan, Attach. 1 at 12. The ARC's modest and capped size, its interim nature, and the requirement to impute revenue from charging ARCs to multi-line business customers as well as to consumers, together with the $30 Residential Rate Ceiling, will ensure that overall rates remain affordable and set at reasonable levels. Further, while it may be that holding companies will allocate ARC amounts to markets where their incumbent LECs face less competitive pressure, those markets would likely be ones that are relatively costly to serve. *See* Letter from Chris Miller, Assistant General Counsel, Verizon, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No 07-135, WC Docket No. 05-337, CC Docket No. 01-92, CC Docket No. 96-45, WC Docket No. 03-109, WC Docket No. 04-36, at 1-2 (filed Oct. 20, 2011).

[1792] In the *USF/ICC Transformation NPRM* we sought comment on allowing carriers to vary the end-user charges based upon network usage, and on further differentiating the magnitude of end-user recovery beyond the categories of customers associated with existing SLC caps. We also sought comment regarding the National Broadband Plan's suggestion that the Commission consider whether to deregulate end user charges in areas where states have deregulated local service rates. *See USF/ICC Transformation NPRM*, 26 FCC Rcd at 4737, para. 583. There was little support for such changes. Particularly given the minimal record support, as well as the possibility for consumer confusion resulting from too many variations of SLCs and potential burdens on end users, we find our approach to recovery more appropriate.

[1793] We decline to adopt other flexibility proposals in the record. For instance, in the *August 3 Public Notice*, we sought comment on the ABC Plan proposal that price cap carriers be allowed to choose between different SLC options depending on whether or not they choose to take ICC revenue recovery from the CAF in addition to end-user charges. *See August 3 Public Notice* , 26 FCC Rcd at 11124-28. We do not find a basis in the record for such differential treatment of customers, and instead adopt a uniform approach for price cap carriers.

[1794] The decision to elect not to receive ICC replacement CAF support, discussed below, is distinct from the decision to assess the full authorized ARC.

[1795] In addition, this calculation will exclude lines for Lifeline customers because we prevent carriers from assessing an ARC on any Lifeline customer.

customers based on the calculation: 1000 residential and single line business lines/(1000 residential and single-line business lines + 2 x 200 multi-line business lines) = 71.43 percent.

912. We decline to implement end user recovery through increases to the pre-existing SLC, as some commenters suggest.[1796] SLCs today are designed to recover common line revenues as defined by Commission regulation. We are not formally recategorizing any costs or revenues to be included in that regulatory category, and the calculation of Eligible Recovery for purposes of the reforms we adopt today is completely independent of SLC rate calculations. As a result, we leave current SLCs unmodified for now.[1797] Instead, the new ARC will be separately calculated, reduced over time, and separately tariffed and reported to the Commission to enable monitoring to ensure carriers are not assessing ARCs in excess of their Eligible Recovery.[1798] Moreover, we find that it is appropriate to reevaluate our SLC rules, and do so in the attached FNPRM.[1799]

913. *Residential Rate Ceiling.* In the *Public Notice*, we sought comment on the appropriate level and operation of a ceiling to limit rate increases in states that already had undertaken some intercarrier compensation reforms.[1800] To ensure that consumer telephone rates remain affordable and to recognize states that have already undertaken reform, we adopt a Residential Rate Ceiling of $30 per month for all incumbent LECs, both price cap and rate-of-return. Although the Residential Rate Ceiling does not generally limit rates carriers can charge, it prevents carriers from charging an ARC on residential consumers already paying $30 or more.

914. For purposes of comparison with the Residential Rate Ceiling, we consider the rate for basic local service, including additional charges that a consumer actually pays each month in conjunction with that service (referred to collectively as rate ceiling component charges). The rate ceiling component charges consist of the federal SLC and the ARC; the flat rate for residential local service,[1801] mandatory extended area service charges, and state subscriber line charges; per-line state high cost and/or access replacement universal service contributions;[1802] state E911 charges; and state TRS charges. Carriers are not permitted to charge ARCs to the extent that ARCs would result in rate ceiling component charges exceeding the Residential Rate Ceiling for any residential customer. For example, a consumer in Parsons,

[1796] *See, e.g.*, Alexicon *USF/ICC Transformation NPRM* Reply at 8; ABC Plan, Attach. 1 at 11-12. *See also, e.g.*, *USF/ICC Transformation NPRM*, 26 FCC Rcd at 436-38, paras. 579-84

[1797] Carriers whose current SLCs are below the caps are not otherwise permitted to increase their SLCs to recover revenues reduced by interstate and intrastate access charge reforms, i.e., we are not permitting carriers to raise their SLCs beyond the level they are currently authorized to charge, even if that level is below the relevant regulatory SLC cap. We seek comment in the accompanying FNPRM regarding whether existing regulation of SLCs is appropriate, including whether SLCs should be reduced or phased-out over time. *See infra* paras. 1330-1333.

[1798] The ARC can, however, be combined in a single line item with the SLC on the customer's bill.

[1799] *See infra* paras. 1330-1333; NASUCA *USF/ICC Transformation NPRM* Comments at 98; Free Press *August 3 PN* Comments at 12-13.

[1800] *Further Inquiry Into Certain Issues in the Universal Service-Intercarrier Compensation Transformation Proceeding*, 26 FCC Rcd 11112 at 11122-23 (2011) (*August 3 Public Notice*) (discussing proposals ranging from $25-30, and their associated implementation).

[1801] This is sometimes known as the "1FR" or "R1" rate. *See, e.g.*, Letter from the Supporters of the Missoula Plan to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, Attach. 1 at 3 (filed Jan. 30, 2007) (Missoula Plan Corrected Jan. 30 *Ex Parte* Letter) (referencing "the basic residential local rate (1FR or equivalent)").

[1802] ABC Plan, Attach. 1 at 12 (describing the rates used for the benchmark comparison).

Kansas may have a rate of $13.90,[1803] a SLC of $6.40, a mandatory contribution to the Kansas Universal Service Fund of $6.75, a mandatory EAS charge of $1.70, and a TRS charge of $1.00—his or her aggregate rate ceiling component charges before the ARC would be $29.75. Accordingly, a carrier could only charge this consumer an ARC of $0.25 before reaching the $30 Residential Rate Ceiling.[1804] (The carrier could still charge multi-line business customers a $1.00 per line ARC, provided that any multi-line business customer's total SLC plus ARC does not exceed $12.20). After the ARC, any additional Eligible Recovery would have to be recovered from the CAF rather than from end-users.

915. The Residential Rate Ceiling particularly helps protect consumers in states that have already begun state intercarrier compensation reform.[1805] As part of such reform, some states are rebalancing rates, with local rate increases phasing in over time, including potentially after January 1, 2012.[1806] These local rate increases will be included in the calculation of end-users rates for comparison to the Residential Rate Ceiling. Further, as part of our universal service reforms, we are adopting an intrastate rate minimum benchmark designed to avoid over-subsidizing carriers whose intrastate rates are not minimally reasonable.[1807] To ensure that states are not disincented from rebalancing artificially low local retail rates after January 1, 2012, and to ensure that our Residential Rate Ceiling continues to protect consumers in those states, we will use the *higher of* the relevant rates in effect on January 1, 2012 or of January 1 in the year in which the ARC is to be charged for comparison to the Residential Rate Ceiling, thus accounting for possible increases in consumer rates over time.[1808]

916. We find the $30 Residential Rate Ceiling will help ensure that consumer rates remain affordable and set at reasonable levels by preventing any ARC increases to consumers who already pay $30 or more.[1809] Although some commenters propose using a $25 (or lower) rate,[1810] we note that several

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[1803] *See* U.S. General Accounting Office, *Telecommunications: Federal and State Universal Service Programs and Challenges to Funding*, at 52 (GAO-02-187, Feb. 4, 2002), http://www.gao.gov/new.items/d02187.pdf ("GAO Report").

[1804] Consistent with the goal of the Residential Rate Ceiling, because non-primary residential SLC lines are charged to residential customers we limit carriers' ARC for non-primary residential SLC lines to an amount equal to the ARC charged for such consumers' primary residential lines. Thus, to the extent that the Residential Rate Ceiling limits the ARC that can be assessed on residential customers' primary lines, it effectively will limit the ARC that can be charged on their non-primary lines, as well.

[1805] *See, e.g.*, Letter from Joel Shifman, Maine Public Utilities Commission, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 1 (filed October 14, 2011) (urging the Commission to recognize early adopter states that have already undertaken intrastate access reform and rate rebalancing).

[1806] *See, e.g.*, Pennsylvania PUC *August 3 PN* Comments at 17.

[1807] *See supra* Section VII.

[1808] *See* ABC Plan Proponents *August 3 PN* Comments at 21-22. Because this approach protects consumers in states that are in the process of rebalancing local rates, we believe it is preferable to the "snapshot" approach others have proposed. *See, e.g.*, ABC Plan, Attach. 1 at 12; Joint Letter at n.1. Although states are free to lower intrastate access rates more quickly than specified by our reform, doing so would not increase the ARC or ICC-replacement CAF support available to carriers in such states. If it accomplished that reform by rebalancing local rates, however, those increased local rates would be accounted for in our Residential Rate Ceiling.

[1809] We note that we also adopt a "local rate benchmark" as part of universal service reform of HCLS and HCMS. *See supra* Section VII.D.5. The CAF benchmark serves a different purpose and has a different function from the Residential Rate Ceiling. The CAF benchmark is focused on ensuring that universal service does not overly subsidize carriers with artificially low local rates. As a result, it focuses more narrowly on the specific rates of concern, especially flat-rated local service charges, state SLCs, and state USF contributions and sets a lower bound to encourage carriers to charge reasonably comparable local rates. HCLS and HCMS are federal universal service (continued…)

states that have rebalanced rates already have rates above $30, suggesting that this rate is affordable and set at reasonable levels.[1811] To the extent that prior surveys of urban rates yielded an average of approximately $25, we observe that the surveys encompassed a more limited set of charges than our Residential Rate Ceiling.[1812] As demonstrated by the rates in a number of states that have undertaken significant intercarrier compensation reform—which we find to be a more relevant data set in this context than average urban rates—rates including the full ranges of charges can be close to or more than $30.[1813] We also decline to adopt separate rate ceilings for different carriers, and instead agree with commenters that it would "be inappropriate—and inconsistent with Section 254—for the Commission to adopt different benchmarks for different geographic areas or providers."[1814] Such an approach would mandate rate disparities between geographic areas, contrary to the Commission's goal of promoting reasonably comparable rates throughout the country.[1815] We thus conclude that the $30 Residential Rate Ceiling

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mechanisms that pick up intrastate loop costs, and we will not use limited universal service funding to subsidize artificially low rates. The CAF benchmark therefore serves as a floor.

We do not use the Residential Rate Ceiling for other purposes, such as an imputed level of revenue to limit a carrier's recovery from the CAF, as some commenters suggest. *See, e.g.*, NASUCA *August 3 PN* Comments at 60. The CAF benchmark includes an imputation and imputing those same revenues twice could be problematic. Moreover, the ICC Residential Rate Ceiling acts as a cap on any federal ARC increases resulting from intercarrier compensation reform, ensuring that overall consumer rates remain affordable. The Residential Rate Ceiling thus considers a wider range of end-user charges and is set at a higher level than the CAF benchmark. Although the Residential Rate Ceiling also helps target end-user rate increases for recovering Eligible Recovery to consumers in states with the lowest rates, those increases alone do not ensure that consumers in those states will ultimately pay rates more comparable to other areas. Thus, the HCLS/HCMS rate benchmark plays a complementary role.

1810 *See, e.g.*, NECA et al. *August 3 PN* Comments at 46; Letter from Michael R. Romano, Senior Vice President – Policy, NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 4 (filed Oct. 17, 2011).

1811 *See, e.g.*, *supra* para. 859; *see also, e.g.*, Letter from Brian J. Benison, Director-Federal Regulatory, AT&T, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-337, CC Docket No. 01-92, GN Docket No. 09-51, Attach. 2 (filed Oct. 25, 2010); Missoula Plan Corrected Jan. 30 *Ex Parte* Letter, Attach. 2 at 1-2 (identifying 27 states estimated to receive proposed universal service funding where "Residential Revenues Per Line" already were greater than $25).

1812 For example, it did not include state universal service contributions. *See, e.g.*, IATD, WCB, Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service, App. at 1 (rel. Aug. 2008) (describing information collected in 2007 urban rate survey).

1813 *See supra* para. 859.

1814 Time Warner Cable *August 3 PN* Comments at 14, 15.

1815 Nor are we persuaded that other considerations justify such disparate treatment of customers based on whether they obtain service from a price cap carrier or a rate-of-return carrier. For example, some commenters contend that rate-of-return carriers have smaller local calling areas, and therefore fewer of their calls are encompassed by local retail rates. *See, e.g.*, MoSTCG *USF/ICC Transformation NPRM* Comments at 10; North Dakota PSC *USF/ICC Transformation NPRM* Comments at 3. As an initial matter, the record contains no reliable data regarding relative local calling area sizes for rate-of-return and price cap carriers generally. In addition, the retail residential rates encompassed by the Residential Rate Benchmark cover both telephone exchange service (i.e., the ability to make calls within a given local calling area) and exchange access (i.e., the ability to connect to an IXC to make long distance calls).

strikes the right balance between ensuring that consumers pay their fair share of recovery and protecting consumers in states that already have undertaken substantial reforms.[1816]

2. CAF Recovery

917. The Commission has recognized that, as we move away from implicit support, some high cost, rural areas may need new explicit support from the universal service fund. Consequently, in the *USF/ICC Transformation NPRM*, the Commission sought comment on the appropriate role of universal service support to offset some intercarrier revenues lost through reform.[1817] We agree with the many commenters advocating that transitional recovery should, in part, come through the CAF. In particular, the limits on ARCs and the Residential Rate Ceiling we adopt above place important constraints on end user recovery. Consequently, we anticipate that end user recovery alone will not provide the full recovery permitted by our mechanism for many incumbent LECs, particularly rate-of-return carriers. Given our desire to ensure a measured, predictable transition, we thus find it appropriate to supplement end user recovery with transitional ICC-replacement CAF support.

918. To that end, as part of the new CAF universal service mechanism, we permit incumbent LECs to recover Eligible Recovery that they do not have the opportunity to recover through permitted ARCs.[1818] The same oversight and accountability obligations we adopt above apply to CAF support received as part of the recovery mechanism.[1819] In addition, all rate-of-return CAF ICC recipients, whether a current recipient of high cost universal service support or not, must satisfy the same public interest obligations as carriers receiving high-cost universal service support. All price cap CAF ICC recipients must use such support for building and operating broadband-capable networks used to offer

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[1816] Some commenters express concerns that our rate ceiling will not absolutely guarantee that states will not have rates that exceed the $30 Residential Rate Ceiling. To the extent that commenters express concern that states subsequently might increase local rates and/or state universal service fund contributions, *see, e.g.*, Kansas Commission *August 3 PN* Reply at 5-7, we note that our rate ceiling will account for future increases in local rates and per line universal service contributions, counting those higher amounts toward the benchmark. The Kansas Corporation Commission also observes that some states have deregulated basic local phone service rates, and thus "a carrier may face no constraint whatsoever in increasing basic local rates." Kansas Commission *August 3 PN* Reply at 6. If carriers were unconstrained in their ability to increase particular rates, it is not clear why they would not already have set them at the profit-maximizing level, such that further increases would not be profitable. States also remain free to reconsider their regulatory approach if problems arise with respect to particular rates.

[1817] *See, e.g., USF/ICC Transformation NPRM*, 26 FCC Rcd at 4738-41, paras. 585-94. *See also, e.g., 2008 Order and ICC/USF FNPRM*, 24 FCC Rcd at 6634-41, App. A, paras. 311-25; *2005 Intercarrier Compensation FNPRM*, 20 FCC Rcd at 4706-4734, paras. 42-44, 51, 53, 55, 58, 59, 101, 104, 109-11.

[1818] The ICC-replacement CAF support for carriers that are eligible and elect to receive it is the remainder of Eligible Recovery not recovered through ARCs. As a result, those same data will enable USAC to calculate CAF support as well. Thus, we direct carriers to file those same data with USAC for purposes of CAF distribution under our recovery mechanism. We note that although incumbent LECs will experience intercarrier compensation reductions on a study area-by-study area basis, they have flexibility at the holding company level to determine where and how to charge ARCs. Thus, USAC needs an approach to attributing those revenues to particular study areas to determine the amount of CAF funding to provide to each such area. In this regard, we note that one benefit of our universal service reform is the greater accountability associated with the CAF support mechanism. Given that, we direct USAC to attribute ARC revenue to all of the holding company's study areas in proportion to the Eligible Recovery associated with that study area. This will ensure that some study areas are not insulated from the CAF accountability measures by having sufficient ARC revenue attributed to meet their entire Eligible Recovery need.

[1819] These obligations are subject to waiver pursuant to the Total Cost and Earnings Review. *See infra* Section XIII.G.

their own retail broadband service in areas substantially unserved by an unsubsidized competitor of fixed voice and broadband services.[1820] We believe it is appropriate to adopt slightly different obligations for receipt of CAF ICC support for price cap and rate-of-return carriers. For one, the price cap CAF support is transitional, and phasing out completely over time as we have adopted a long-term phase II CAF support for areas served by price cap carriers. Thus, we have a mechanism to advance our goal of universal voice and broadband to areas served by price cap carriers that are unserved today. For rate-of-return carriers, however, we have not adopted a different long-term approach for receipt of universal service support. Therefore, we believe it is appropriate to impose the same obligations that such carriers have for receipt of all universal service support that we adopt above, which requires carriers to extend broadband upon reasonable request [1821] Finally, we allow a carrier to elect not to receive ICC replacement CAF support (and therefore to avoid the obligations that accompany support) even if it would otherwise be entitled to do so under the Eligible Recovery calculation.[1822]

919. Providing CAF recovery is consistent with our mandate under section 254[1823] and the Commission's use of universal service funding as a component of prior intercarrier compensation reforms.[1824] In light of the broadband obligations we adopt, our decision to establish this funding mechanism is also consistent with our general authority under section 4(i) of the Act[1825] and section 706 of the 1996 Act,[1826] because it furthers our universal service objectives and promotes the deployment of advanced services. [1827]

1820 Consistent with our discussion of obligations associated with frozen high-cost support for price cap carriers in Section VII.C.1 above, while we expect CAF ICC recipients to use support in areas without an unsubsidized competitor, to the extent support is used to serve any geographic area that is partially served by an unsubsidized competitor, the recipient must certify that at least 50 percent of the locations served are in census blocks shown as unserved by an unsubsidized competitor, as shown on the National Broadband Map. *See supra note* 168. *See also* Letter from Jonathan Banks, USTelecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 10-90; GN Docket No. 09-51; WC Docket No. 07-135; WC Docket No. 05-337; CC Docket No. 01-92; CC Docket No. 96-45; WC Docket No. 04-36 at 1-2 (filed Oct. 21, 2011).

1821 CAF ICC support must also be used to support the speed, latency and usage levels adopted above. *See supra* Section VII.D.

1822 The election to decline CAF support will be made in the carrier's July 1, 2012 tariff filing. A carrier that elects not to receive CAF cannot subsequently change this election. A carrier can, however, initially elect to receive CAF support but elect to end that support at any time. Moreover, like forgone ARC recovery, forgone CAF will be imputed to a carrier seeking any additional recovery under the Total Cost and Earnings Review, discussed below. *See infra* Section XIII.G.

1823 47 U.S.C. § 254(i) (requiring that "[t]he Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable"); 47 U.S.C. §254(b)(1) (stating that "[q]uality services should be available at just, reasonable, and affordable rates").

1824 *See, e.g., CALLS Order*, 15 FCC Rcd at 12971, para. 24; *MAG Order*, 16 FCC Rcd at 19669–70, para. 132.

1825 Section 4(i) provides that the Commission may "perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this chapter, as may be necessary in the execution of its functions." 47 U.S.C. § 154(i). Prior to the enactment of section 254 (as part of the 1996 Act), sections 1 and 4(i) provided authority for the Commission's adoption of a universal service fund. *See Rural Telephone Coalition v. FCC*, 838 F.2d 1307 (D.C. Cir. 1988). *See also New England Telephone and Telegraph Co. v. FCC*, 826 F.2d 1101, 1107 (D.C. Cir. 1987) (describing section 4(i) as a "wide-ranging source of authority"), *cert. denied*, 490 U.S. 1039 (1989).

1826 47 U.S.C. § 1302.

1827 *See supra* Section V.

920. For price cap carriers that elect to receive ICC-replacement CAF support, such support is transitional and phases out in three years, beginning in 2017.[1828] Although we do not adopt a similar sunset for rate-of-return carriers' ICC-replacement CAF support in this Order, we seek comment on alternatives in this regard in the FNPRM.[1829]

3. Monitoring Compliance with Recovery Mechanism

921. To monitor compliance with this Order, we require all incumbent LECs that participate in the recovery mechanism, including by charging any end user an ARC, to file data on an annual basis regarding their ICC rates, revenues, expenses, and demand for the preceding fiscal year.[1830] All such information may be filed under protective order and will be treated as confidential.

922. These data are necessary to monitor compliance with the provisions of this Order and accompanying rules, including to ensure that carriers are not charging ARCs that exceed their Eligible Recovery and that ARCs are reduced as Eligible Recovery decreases. The data are also needed to monitor the impact of the reforms we adopt today and to enable the Commission to resolve the issues teed up in the FNPRM regarding the appropriate transition to bill-and-keep and, if necessary, the appropriate recovery mechanism for rate elements not reduced in this Order, including originating access and many transport rates. Such data will enable the Commission to determine the impact that any transition would have on a particular carrier or group of carriers, and to evaluate the trend of ICC revenues, expenses, and minutes and compare such data uniformly across all carriers.

923. To minimize any burden, filings will be aggregated at the holding company level, limited to the preceding fiscal year, and will include data carriers must monitor to comply with our recovery mechanism rules. For carriers eligible and electing to receive CAF ICC support, we will ensure that the data filed with USAC is consistent with our request, so that carriers can use the same format for both filings. To ensure consistency and further minimize any burden on carriers, we delegate to the Wireline Competition Bureau the authority to adopt a template for submitting the data, which should be done in conjunction with the development of data necessary to be filed with USAC for receipt of CAF ICC support, which has also been delegated to the Wireline Competition Bureau.[1831] Given that carriers must be monitoring these data to comply with our revised tariff rules, we require incumbent LECs to file electronically annually at the same time as their annual interstate access tariff filings.

G. Requests for Additional Support

924. Although we provide an opportunity for revenue recovery to promote an orderly transition away from terminating access charges, we decline to adopt a revenue-neutral approach as advocated by some commenters.[1832] Rather, we agree with commenters who maintain that the

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[1828] *See, e.g.,* ABC Plan, Attach. 1 at 12-13.

[1829] *See infra* para. 1328.

[1830] We also encourage, but do not require, all competitive LECs and CMRS providers to similarly file such data.

[1831] Although the Commission requested such data in the *USF/ICC Transformation NPRM*, such submission was often incomplete and not filed in the same format by all carriers. *See USF/ICC Transformation NPRM*, 26 FCC Rcd at 4733, para. 572 and n.853.

[1832] *See, e.g.*, CenturyLink *USF/ICC Transformation NPRM* Comments at 63 ("All carriers should have an opportunity to replace all ICC revenue lost as a result of rate reform."); Mississippi Public Commission *USF/ICC Transformation NPRM* Comments at 15 ("[W]ireline carriers, incurring both intrastate and interstate access reductions, should be 'made whole.'"); Letter from Michael R. Romano, Senior Vice President – Policy, NTCA, to (continued…)

Commission has no legal obligation to ensure that carriers recover access revenues lost as a result of reform, absent a showing of a taking.[1833] We establish a rebuttable presumption that the reforms adopted in this Order, including the recovery of Eligible Recovery from the ARC and CAF, allow incumbent LECs to earn a reasonable return on their investment. We establish a "Total Cost and Earnings Review," through which a carrier may petition the Commission to rebut this presumption and request additional support.[1834] We identify below certain factors in addition to switched access costs and revenues that *may* affect our analysis of requests for additional support, including: (1) other revenues derived from regulated services provided over the local network, such as special access; (2) productivity gains; (3) incumbent LEC ICC expense reductions and other cost savings, and (4) other services provided over the local network.[1835] Particularly given these factors, it is our predictive judgment that the limited recovery permitted will be more than sufficient to provide carriers reasonable recovery for regulated services, both as a matter of the constitutional obligations underlying our rate regulation and as a policy matter of providing a measured transition away from incumbent LECs' historical reliance on intercarrier compensation revenues to recovery that better reflects today's marketplace.[1836] Nonetheless, we also adopt a Total Cost and Earnings Review to allow individual carriers to demonstrate that this rebuttable presumption is incorrect and that additional recovery is needed to prevent a taking.

925. To show that the standard recovery mechanism is legally insufficient, a carrier would face a "heavy burden,"[1837] and need to demonstrate that the regime "threatens [the carrier's] financial integrity or otherwise impedes [its] ability to attract capital."[1838] As the Supreme Court has long

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Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Docket Nos. 01-92, 96-45 at 3 (filed Oct. 18, 2011).

[1833] Ad Hoc *USF/ICC Transformation NPRM* Comments at 51; AT&T *USF/ICC Transformation NPRM* Comments at 32; NASUCA *USF/ICC Transformation NPRM* Reply at 12; Letter from Scott Bergman, CTIA, to Marlene H. Dortch, Secretary, FCC GN Docket No. 09-51; WC Docket Nos. 96-45, 05-337, 10-90; CC Docket No. 01-92 (filed Sept. 9, 2011).

[1834] We believe the Total Cost and Earnings Review procedure alone is sufficient to meet our legal obligations with regard to recovery.

[1835] *See infra* Section XIII.G. *See also USF/ICC Transformation NPRM*, 26 FCC Rcd at 4729, para. 562 (seeking comment on the extent of the Commission's legal obligation to provide a recovery mechanism); *id.* at 4730, para. 563 (the relationship with jurisdictional separations considerations); *id.* at 4731, para. 567 (the relevant revenues to include for recovery purposes); *id.* at 4731-32, paras. 568-69 (the implications for recovery of other services provided using the same multi-purpose networks); *id.* at 4732, para. 570 (the appropriate baseline, including disputed revenues); *id.* at 4732-33, para. 571 (the role of cost savings); *see also August 3 Public Notice*, 26 FCC Rcd at 11125-26 (seeking comment on an approach that would incorporate specified reductions in the recovery baseline, allowing carriers to realize the benefits of reduced costs and/or greater efficiency); *id.* at 16 (whether carriers seeking recovery should have to demonstrate need based on their operations more broadly); *2008 Order and ICC/USF FNPRM*, 24 FCC Rcd at 6640, App. A, para. 324 (seeking comment on a recovery mechanism that would consider all a carrier's costs and revenues when evaluating the need for recovery); *2005 Intercarrier Compensation FNPRM*, 20 FCC Rcd at 4730-31, paras. 99-100 (seeking comment on the scope of any legal obligation to provide a recovery mechanism, including the relevance of revenues from a carrier's other services and of cost savings).

[1836] See *Time Warner Entertainment Co., L.P. v. F.C.C.*, 240 F.3d 1126, 1133 (D.C. Cir. 2001) ("Substantial evidence does not require a complete factual record-we must give appropriate deference to predictive judgments that necessarily involve the expertise and experience of the agency.") citing *Turner II*, 520 U.S. at 196, *Federal Communications Commission v. National Citizens Comm. for Broadcasting,* 436 U.S. 775 at 814 (1978).

[1837] *Hope Natural Gas,* 320 U.S. at 602.

[1838] *Illinois Bell Telephone Co. v. FCC*, 988 F.2d 1254, 1263 (D.C. Cir. 1993).

recognized, when a regulated entity's rates "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed," the company has no valid claim to compensation under the Takings Clause, even if the current scheme of regulated rates yields "only a meager return" compared to alternative rate-setting approaches.[1839] For the reasons described above, we believe that our recovery mechanisms provide recovery well beyond any constitutionally-required minimum, and we find no convincing evidence in the record here that the standard recovery mechanism will yield confiscatory results.

926. Specifically, a carrier can petition for a Total Cost and Earnings Review to request additional CAF ICC support and/or waiver of CAF ICC support broadband obligations.[1840] In analyzing such petitions, the Commission will consider the totality of the circumstances, to the extent permitted by law.[1841] Our analysis will consider all factors affecting a carrier and its ability to earn a return on its relevant investment, including the factors described below. As a result of this analysis of costs and revenues, the Commission will be able to determine the constitutionally required return and will not be bound by any return historically used in rate-setting nor any specific return resulting from the intercarrier compensation recovery mechanism adopted in this Order,[1842] or possible rate represcription as discussed in the FNPRM.[1843]

927. As we seek to protect consumers from undue rate increases or increases in contributions to USF, we will conduct the most comprehensive review of any requests for additional support allowed by law. Our recovery mechanism goes beyond what might strictly be required by the constitutional takings principles underlying historical Commission regulations. Therefore, although our standard recovery mechanism does not seek to precisely quantify and address all considerations relevant to resolution of a takings claim, carriers will need to address these considerations to the extent that they seek to avail themselves of the Total Cost and Earnings Review procedure based on a claim that recovery is legally insufficient.[1844]

928. *Revenues Derived from Other Regulated Services Provided Over the Local Network.* We agree with those who argue that it is appropriate for the Commission to consider the implications of services other than switched access that are provided using supported facilities,[1845] to the extent

[1839] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).

[1840] *See supra* para. 918.

[1841] *See, e.g.*, Comcast *August 3 PN* Comments at 16-19 (claiming that "there is no Congressional or FCC prohibition against the Commission's consideration of unregulated revenues when determining the appropriate level of subsidies for regulated services").

[1842] Given the extensive discussion of reform proposals over the years, a carrier could not reasonably "rely indefinitely" on the existing system of intercarrier compensation, "but would simply have to rely on the constitutional bar against confiscatory rates" in the event the Commission revised its compensation rules. *Verizon Communications Inc. v. FCC*, 535 U.S. 467, 528 (2002).

[1843] *See infra* Section XVII.C.

[1844] *See infra* Section XIII.G.

[1845] *See, e.g.*, ITTA *USF/ICC Transformation NPRM* Comments of at 38 ("It is, of course, reasonable to require CAF recipients to account for the expected revenues from supported services."); CBeyond et al. *USF/ICC Transformation NPRM* Comments at 16. *But see* NECA et al. *USF/ICC Transformation NPRM* Comments at 18 ("any decision by the Commission to take into consideration the extent to which RLECs or other regulated carriers earn revenues from non-regulated services would appear to represent a dramatic about-face in Commission regulatory policy, which has for more than forty years emphasized the importance of keeping regulated and non-regulated costs and revenues separate. This principle has been one of the cornerstones of the Commission's regulatory policy, on which its Part 64 Joint Cost Rules and numerous orders dealing with activities as diverse as (continued...)

constitutionally permitted.[1846] Notwithstanding our intercarrier compensation reform, carriers will continue to receive revenues from other uses of the local network. For example, although the reforms adopted in this Order will bring many intercarrier compensation rates into a bill-and-keep framework, other intercarrier compensation rates will be subject to minimal—or no—reforms at this time.[1847] Consequently, incumbent LECs will continue to collect intercarrier compensation for originating access and dedicated transport, providing continued revenue flows—including the underlying implicit subsidies—from those sources during the transition outlined in this Order, although we have determined that such rates ultimately will reach bill-and-keep as well. Carriers acknowledge that the subsidies in these remaining intercarrier compensation rates are used for investment in their network to provide regulated services such as special access service. In addition, there was debate in the record regarding whether, and how, to consider special access revenues in this regard.[1848] At this time we do not prescribe general rules considering such revenue, but, as with other services that rely on the local network, we will consider such earnings and may reconsider this decision if warranted upon conclusion of the Commission's ongoing special access proceeding.[1849]

929. *Productivity Gains*. As discussed above, although incentive regulation commonly involves sharing the benefits of productivity gains between carriers and ratepayers, such a mechanism has not been in place for many years.[1850] Our standard recovery mechanism adopts a 10 percent reduction in *CALLs* price cap incumbent LECs' baseline revenues, initially for *CALLS* price cap study areas, and after five years for non-CALLS price cap study areas to reflect this. However, because we believe that is a conservative approach, we find it appropriate to consider efficiency gains for particular price cap carriers on an individual basis in our Total Cost and Earnings Review, as well.

930. *LEC Cost Savings and Increased Revenue*. Currently, carriers are frequently embroiled in costly litigation over payment, jurisdiction, and type of traffic.[1851] The reforms we adopt today should substantially reduce such disputes,[1852] and we anticipate that comprehensive intercarrier compensation

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Yellow Pages advertising to Video Dialtone Services to wireline broadband Internet access services rest." (footnotes omitted)).

[1846] *See, e.g.*, *Hope Natural Gas,* 320 U.S. at 602 (when performing a takings analysis, it is necessary to consider "the total effect" of the challenged regulation); *see also, e.g.*, *Baltimore & Ohio Railroad Co. v. United States,* 345 U.S. 146, 148 (1953); *Puget Sound Traction, Light & Power Co. v. Reynolds,* 244 U.S. 574, 579-81 (1917); *Consolidated Edison Co. v. Pataki,* 292 F.3d 338, 351 (2d Cir. 2002).

[1847] *See supra* Section XII.A.

[1848] *Compare, e.g.*, Ad Hoc *USF/ICC Transformation NPRM* Comments at 51-53; NASUCA *August 3 PN* Reply at 151 *with, e.g.*, CenturyLink *USF/ICC Transformation NPRM* Comments at 68; ITTA *August 3 PN* Reply at 11.

[1849] *See generally Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25, RM-10593, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994 (2005).

[1850] *See supra* para. 881.

[1851] *See, e.g.*, Letter from Paul Kouroupas, Vice President, Regulatory Affairs, Global Crossing North America, Inc., to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92 at 1 (filed Dec. 17, 2010) (Global Crossing Dec. 17, 2010 *Ex Parte* Letter) (estimating that disputes regarding intercarrier compensation may represent $450,000,000 annually).

[1852] *See* Sections XI.A and B, XIV, and XV. *See also USF/ICC Transformation NPRM*, 26 FCC Rcd at 4702, 4710, paras. 493, 507.

reform will further reduce carriers' costs of administering intercarrier compensation.[1853] Likewise, our actions regarding phantom traffic and intercarrier compensation for VoIP traffic may increase the proportion of traffic for which intercarrier compensation can be collected. Finally, we note that our reforms should result in expense savings in other lines of business, such as the provision of long distance services. Although we do not adopt a "net revenues" approach as part of our standard recovery mechanism,[1854] in appropriate circumstances we believe an analysis of intercarrier expenses could be warranted in the examination of an individual carrier's claim under the more fact- and carrier-specific Total Costs and Earnings Review mechanism.[1855] We will consider these factors to the extent legally permissible, including but not limited to the following categories:

- *Revenue for Exchanging VoIP Traffic.* A number of carriers have alleged that they are not receiving compensation for exchanging VoIP traffic.[1856] In this Order we adopt rules clarifying the obligation of VoIP traffic to pay intercarrier compensation charges during the transition to bill and keep.[1857] The decisions we adopt today will provide LECs, including incumbent LECs, with more certain revenue throughout the transition, and will also allow them to avoid the litigation expense associated with attempts to collect access charges for VoIP traffic.[1858]
- *Reduced Phantom Traffic.* Similarly, the rules adopted in this Order will enable carriers to identify and bill for phantom traffic.[1859] These rules thus should enable carriers to collect intercarrier compensation charges throughout the transition that they are not currently able to collect. We also anticipate that incumbent LECs will be able to reduce administrative and litigation costs associated with such traffic.[1860]
- *Other Reduced Litigation Costs and Administrative Expenses.* In addition to reduced litigation costs and administrative expense associated with VoIP and phantom traffic as a result of the reforms we adopt in this Order, the record indicates that carriers will benefit more generally from the clarity and

[1853] *See, e.g., USF/ICC Transformation NPRM*, 26 FCC Rcd at 4732, para. 570 (seeking comment on the appropriate baseline, including disputed revenues); *2005 Intercarrier Compensation FNPRM*, 20 FCC Rcd at 4730-31, paras. 99-100 (seeking comment on the scope of any legal obligation to provide a recovery mechanism, including the relevance of revenues from a carrier's other services and of cost savings); *id.* at 4767, para. 193 (discussing benefits to small entities from ICC reform due to reduced administrative expenses and disputes).

[1854] *See supra* paras. 874-878.

[1855] *See, e.g., Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements; 2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, WC Docket No. 02-112; CC Docket No. 00-175, Report and Order and Memorandum Opinion and Order, 22 FCC Rcd 16440 (2007) (permitting certain incumbent LECs to integrate their LEC and IXC operations without becoming subject to dominant carrier regulation of those interexchange services); *Petition of AT&T Inc. for Forbearance under 47 U.S.C. § 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, WC Docket Nos. 07-21, 05-342, Memorandum Opinion and Order, 23 FCC Rcd 7302, 7312-13, para. 19 n.71 (2008) (quoting AT&T Reply comments stating that "a price cap ILEC raising a confiscation claim may find it more difficult to prove such a claim without separated cost data").

[1856] *See infra* Section XIV.B.

[1857] *See infra* Section XIV.C.

[1858] *See infra* paras. 937-939.

[1859] *See supra* Section XI.B.

[1860] *See supra* paras.705.

relative simplicity of the rules we adopt today. We anticipate that this will be reflected in additional savings in litigation and administration costs.[1861]

- *Other Services Provided Over the Local Network.* In addition to regulated services provided over the local network, many carriers also provide unregulated services, such as broadband and video. Although parties have identified some uncertainty regarding the Commission's ability to consider revenues from such services in calculating a carrier's return on investment in the local network,[1862] the Commission will, at a minimum, carefully scrutinize the allocation of costs associated with such services. As one commenter states, "[i]t simply no longer makes any sense (if it ever did) for the agency to allow rural carriers to spend as much as they can on their networks, earning a rate of return on these historical costs while only considering the small sliver of regulated local telephony revenues earned using these USF subsidized networks."[1863]

931. We note that some carriers argued that the Commission should not rely on revenue from unregulated services to offset a carrier's defined eligible revenue, but that if it did, it should only use net unregulated revenue, considering both the costs and revenues from those services.[1864] In addition, although there are a range of possible approaches for allocating many types of costs, a number of commenters recognized that historical accounting underlying intercarrier compensation rates and other charges fail to reflect the marketplace reality of the number and types of services provided over the local network.[1865] For example, the record revealed concerns about the extent to which loop costs have been allocated to regulated services such as voice telephone service versus services such as broadband Internet access service.[1866] Consequently, we will give appropriate consideration to these services as part of the Total Cost and Earnings Review, including an analysis of both the revenue generated by such other services and whether the cost of such services, both regulated and unregulated, have been properly allocated.

932. *Cost Allocation.* The *USF/ICC Transformation NPRM* sought comment on the implications of the jurisdictional separations process, including ongoing reform efforts, on intercarrier

[1861] *See* Global Crossing Dec. 17, 2010 *Ex Parte* Letter at 2 (filed Dec. 17, 2010) ("Global Crossing spends approximately 2,290 man hours per month managing the inter-carrier compensation regime. Bill reconciliation and disputes constitutes approximately 750 man-hours per month. Management of the inter-carrier compensation regime through contract negotiation, routing, costing, pricing, and product support constitutes an additional 1,540 man-hours per month. Time and resources devoted to inter-carrier compensation is time and resources that cannot be devoted to customer service and network management.").

[1862] *See, e.g.,* Alexicon *August 3 PN* Comments at 9. *But see* California PUC *USF/ICC Transformation NPRM* Comments at 20.

[1863] Free Press *USF/ICC Transformation NPRM* Comments at 8. *See also, e.g.,* NASUCA *USF/ICC Transformation NPRM* Reply at 154-155 ("[T]argeting the SLC for rate increases is not appropriate, especially if such an increase is pursued outside of a full evaluation of the regulated and non-regulated operations of the LEC.").

[1864] NECA *et al. USF/ICC Transformation NPRM* Comments at 19; CenturyLink *USF/ICC Transformation NPRM* Comments at 68.

[1865] *See, e.g.,* Comcast *USF/ICC Transformation NPRM* Comments at 19 (in assessing the need for high-cost support in the future, the Commission should look at the carriers' regulated and non-regulated revenues as well as technological advances and the efficiencies that companies realize when they provide multiple services over a single network").

[1866] *See, e.g.,* Ad Hoc *USF/ICC Transformation NPRM* Comments at 51-52; Free Press *USF/ICC Transformation NPRM* Comments at 8; NASUCA *August 3 PN* Comments at 70-71.